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INVESTING IN ILS THROUGH GUERNSEY

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Richard Searle of BDO discusses the ILS market in Guernsey and his expectations for future growth.

HFMWeek (HFM): How has the global insurance-linked securities (ILS) market developed over the past 12 months?

Richard Searle (RS): The global ILS market has developed significantly in recent years with 2014 showing a record breaking year with over $24.3bn on risk covering catastrophe bonds at 31 December 2014, according to the Aon Benfield fourth-quarter 2014 update. Strong investor demand has fed larger transactions across the market with coverage being extended into a variety of risks, some of which are outside the traditional catastrophe bond market.

HFM: Will the changes announced in this year's UK budget (allowing ILS to be domiciled in the UK) affect other jurisdictions in terms of competition and volumes of business? What can Guernsey offer that the UK cannot?

RS: The timing of George Osborne's announcement on 18 March 2015 that the government will explicitly target ILS in a plan to grow the London insurance market was particularly interesting considering it fell on the same day that Guernsey Finance presented its ILS Insight London at the British Museum.

The general response to the announcement was that this reinforces recognition of the ILS market as an important piece of the financial services jigsaw. One could take the view that London would be a new competitor to Guernsey in this particular sector though I see a broader welcoming of the announcement. Specifically, this demonstrates recognition of the maturity of this market and of ILS as an asset class that is now considered to be more mainstream than alternative.

Regarding other jurisdictions, there are clearly a number of locations that have been offering ILS products very successfully for many years. Any successful product is bound to attract new entrants to the market and this is to be welcomed. In terms of the impact on Guernsey and what it can offer that the UK cannot, I think it is more beneficial to focus on how Guernsey offers solutions to the market as opposed to looking for unique selling points.

The long history of innovative insurance, PCC and ICC structures in Guernsey, supported by the mature fund, fiduciary, accounting and legal industries means that there is a high concentration of extensive expertise in Guernsey operating under a stable regulatory environment, the size and experience of which means that Guernsey can respond rapidly to changes in the market place.

HFM: There has been a growth in hedge funds launching reinsurance arms. What do you think of this trend?

RS: The growth in hedge funds launching reinsurance arms could be seen as a natural development in an industry that is always on the lookout for opportunities for its investors. A number of hedge funds have operated in this space for quite some time and the formalisation of this structuring through reinsurance arms again reinforces the attractiveness of insurance products as part of an investment strategy.

When considering yields across certain asset classes in recent years it is easy to see why insurance would be an attractive option, particularly given the lack of correlation between insurance risk and the market risk that affects many other asset classes. Nevertheless, there are clearly hurdles to be overcome for any fund managers considering a foray into the insurance market, not least being the regulatory environments, costs and minimising management's distraction from the core business of the hedge fund.

One solution that we have seen working very well to this is where fund managers have invested into ILS products through existing ILS structures, which are typically in cell company models such as Aon's White Rock Insurance Company PCC Limited, White Rock Insurance (Guernsey) ICC Limited and Robus Group's Hexagon Insurance PCC. The advantage of such structures is that they allow investors to diversify their asset class risk whilst still giving them the reassurance that comes with a well regulated and governed structure in an established and stable environment, yet in a relatively low cost investment platform.

Cellular structures can operate with multiple investment managers investing into different cells as in the aforementioned models, or alternatively with a single investment manager invested into an entire PCC or ICC using multiple cells for different funds, as in the case with Secquaero Re (Guernsey) ICC Limited, managed by Aon Insurance Managers Guernsey. Both solutions have equally compelling arguments in their favour and the adoption of one or the other really depends on the specific circumstances of the individual manager, fund(s), and investor bases involved.

HFM: How does the ILS market in Guernsey compare to rival domiciles?

RS: As mentioned before, there are a number of jurisdictions that offer ILS products and it would be difficult to select the unique selling point that can be used to claim dominance over all other domiciles. Similarly within each jurisdiction there will clearly be appropriate pairings between ILS providers and their typical client base and geographies.

I think Guernsey enjoys a concentration of core expertise with significant experience in insurance and investment management as well as accounting and legal experience. Furthermore, the nature of the fund and insurance industries in Guernsey has created a significant level of experience not just in locally-based structures but also in international financial services regulation and structuring.

Finally, the regulatory environment has developed over the past three decades to evolve into a robust yet proportionate regulatory framework in which a key selling point for Guernsey is the speed of response and ease of access to the regulator.

HFM: In which direction do you predict cat bond yields will go over the next 12 to 18 months?

RS: The prediction of cat bond yields is a complex matter. That said, it is clear that cat bond yields have been falling in recent times as have reinsurance rates, and these may well be a simple effect of supply and demand. It is important that any investment manager continues to look not just at yields but also at the level of returns relative to the risks involved in the asset class and the diversity of the fund's portfolio.

HFM: How do you see the ILS sector developing over the next five years in terms of investor interest?

RS: The next five years promise to be an interesting and exciting time in the development of the ILS sector. The increasing level of awareness in recent years in this sector has created additional demand which has most likely had an effect on pricing.

I think there will continue to be an expansion of ILS products into other risks in addition to the more traditional catastrophe bond products, and we have already seen this in the market with a Shariah-compliant listed bond accessing life assurance risk, and with longevity risk transfer products. There will also likely be an impact of technology and a greater move towards insurance products reporting in-line with investor demands.

In fact we have already seen this with discussions around the reporting of daily NAVs on one ILS client to its investor funds. This will present an interesting balancing act between investors' desire to respond quickly to events and what is essentially an illiquid and long-term underlying asset class.

In summary, the future looks exciting for the ILS sector with greater interest and investor appetite being seen from funds and it is encouraging that Guernsey is very well placed to provide innovative solutions to meet investor needs.

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